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In The
Supreme Court of the United States

UNITED STATES OF AMERICA,

Petitioner,

v.

FIOR D'ITALIA, INC.,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

RESPONDENT'S BRIEF

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QUESTION PRESENTED

Whether Congress has conferred upon IRS the authority to base employer FICA taxes on an inherently inaccurate aggregate estimate of total tips received by all employees collectively, and thus shift to the employer the burden of proving the actual taxable tips, which it has no way of ascertaining.

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STATEMENT

This case involves the issuance of a Notice and Demand by the Internal Revenue Service ("IRS") to Fior D'Italia ("Fior") for Federal Insurance Contribution Act ("FICA") taxes on tip income which employees allegedly received but failed to report to Fior. The additional FICA taxes in the Notice and Demand were based on an estimation of gross tips received by all of Fior's employees collectively, rather than a determination of the tip earnings of Fior's individual employees. Fior challenged the assessment, contending Congress did not impose, and IRS is not authorized to assess, FICA taxes on employers based on an aggregate estimate of the collective tip income of all employees. Instead, Fior contends the tax must be based on a determination of the tip earnings of individual employees. Both the district court and the court of appeals agreed, with the appellate court ultimately holding that "there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned." Pet. App. 13a, 51a.

Three circuit courts which have considered this issue, as well as the dissent below, have opined otherwise. However, these opinions are based entirely upon the faulty premise that *Chevron* deference is owed to IRS even in the absence of any articulation by IRS of its interpretation of the statutory provisions. Pet. App. 23a-30a. This court's opinion last term in *United States v. Mead*, 533 U.S. 218 (2001), holds otherwise.

Background. The collection of taxes on tip income presents a serious administrative difficulty for the IRS.

For more than 50 years, Congress and IRS have been grappling with the problem. Under state and federal labor and common law, tips are the sole and exclusive property of the employee. *Williams v. Jacksonville Terminal Co.*, 315 U.S. 386, 397 (1942). Since tips are paid by customers directly to employees, and shared among employees in varying unknown amounts, Congress has repeatedly and consistently refused to permit the employer to become involved in the tipping transaction or to hold the employer responsible for the accounting of tip income. Instead, Congress has placed the responsibility for reporting tip income squarely on tipped employees. In turn, Congress has armed the IRS with the power and means to investigate employee underreporting of tip income and to enforce accurate reporting by employees.

IRS is not happy with the arrangement, however, and has continually attempted to shift its own burden of determining unreported tip income to the employers of tipped employees on the basis of a misconception that the restaurant is "in an inherently better position than the IRS to determine what its employees actually earned in tips." (Gov. Br. "G.B." 38) This fundamental disagreement between Congress and IRS has led to numerous clashes, manifested in the history of the relevant statutes.

Although tips have long been subject to income taxes, since they were not paid by the employer, for many years, they were not considered "wages" for FICA purposes. Initially the employer had no responsibility for the collection and withholding of taxes on tips received. Congress, Treasury, and the Department of Labor all recognized that "tips are an extremely unique type of income."

S. Rep. No. 404, 89th Cong., 1st Sess. (1965), 1965-2 C.B. 758. They recognized that tips are a gratuity payment made directly to one who serves him, the amount of which, if any is determined solely by the customer, and that tips are often split among employees in various tip splitting or pooling arrangements. *See* Rev. Rul. 59-252, 1959-2 C.B. 215; 29 C.F.R. § 531.52; H.R. Rep. No. 213, 89th Cong., 1st Sess. (1965), 1965-2 C.B. 749.

But in 1964, at the request of restaurant employers and employee unions, Congress "recognize[d] that more than a million employees now covered by the social security program have an important part of their income from work excluded from coverage because it is received in the form of tips, and that as a consequence such employees do not have adequate protection under social security." S. Rep. No. 404, *supra*. *See also* H.R. Rep. No. 213, *supra* ("Coverage of tips will provide better protection under the social security program for more than a million employees and their dependents."). Congress "concluded that it would be appropriate . . . to count tips toward benefits" and therefore subjected tips to the *employee* share only of the FICA tax in order to give employees social security credit for their tip wages. *See* P.L. 89-97 § 313(c) (effective 1965).

However, since tips were not a payment from the employer to the employee but a payment from an independent third party to the employee, the employer was not charged an employer share of FICA tax on the tips at that time. This exclusion of tips from the definition of "wages" for purposes of the employer FICA tax remained

in effect for nearly 25 years until the amendments to 26 U.S.C. 3121(q), here in issue.[1]

At the time Congress made the decision to count tip income for social security benefit purposes, Congress recognized that tips presented a unique problem because they were not paid by the employer, were the exclusive property of the employee, and were often not reported by employees for income tax purposes. Congress realized that "only a small fraction" of tip income was actually reported, and attempted to "devise a fair and practical system for obtaining information on amounts of tips received by an individual which could serve as a basis for contributions and benefit credits." H.R. Rep. No. 213. Congress "decided that the only equitable way of counting tips towards benefits is on the basis of actual amounts of tips received and that the only practical way to get this information is to require employees to report their tips to the employer." *Id.*[2]

Accordingly, Congress limited the employer's responsibility for and involvement with respect to tip income to an obligation to withhold under 26 U.S.C. 3101,

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[1] In 1977, Congress did change the law to require employers to pay FICA taxes on tips to the extent they were used to offset an employer's minimum wage obligations. Social Security Amendments of 1977, Pub. L. No. 95-216, § 315(a), 91 Stat. 1509, 1536, repealed by Pub. L. No. 100-203, Title IX, § 9006(b)(2), 101 Stat. 1330-289 (1987). H.R. Rep. No. 95-702, 95th Cong., 1st Sess. 11 (1977), reprinted in 1977 U.S.C.C.A.N. 4155, 4168.

[2] This decision was coupled with the enactment of a penalty equal to 50% of the taxes due if the employee fails to report his tips to the employer. *See* 26 U.S.C. 6652(b).

et seq., and 26 U.S.C. 3401, et seq., exclusively on the basis of reports of tip income filed by employees with the employer pursuant to 26 U.S.C 6053(a). In turn, IRS was charged with the responsibility for enforcing the accuracy of such reporting. Ever since, IRS has attempted to construe the law otherwise.

IRS's first attempt to shift to employers its responsibility for monitoring, verifying and effectively enforcing the law was to read into the employee reporting provisions of Section 6053(a) a requirement that the employer audit and verify the accuracy of the amounts reported by employees to employers on Form 4070. In response, the District Court in *Norfolk Yacht and Country Club v. United States*, 75-2 USTC 9849 (E.D. Va., 1975), held:

> The United States may feel that all employees may not accurately report their monthly tip receipts to employers, but it is incorrect in assuming that the employer has any duty to insure that the amount actually reported is true and accurate. The United States would have plaintiff be its watchdog and that is not contemplated within section 6053. The employer is not ultimately responsible for accuracy, but the employee himself is, as is reflected in 26 U.S.C. § 6652(c). If the United States is concerned with dishonest taxpayers it has the means to investigate them; but the investigative burden should not be shifted to the withholding employer in the absence of Congressional intent to do so. *The court finds that the plaintiff's sole method of reporting, for FICA and withholding tax purposes, is by*

> *use of Form 4070 and that such method is all that is required of plaintiff as a matter of law.*

Id. (emphasis added).

A year later, purporting to act under Section 6041(a), IRS issued a series of Revenue Rulings which would have obligated employers to include on each W-2 issued to an employee all charged tips turned over to that employee. Rev. Rul. 75-400, 1975-2 C.B. 464 and 76-231, 1976-1 C.B. 378. Employers protested that IRS failed to consider the fact that employees are required under the law to report only what they retain after tipping out and that the charged tip amounts could well be in excess of that amount. *See* Reg. 31.3121(q)-1(c). They also argued that many employers do not track credit card sales by employee and no employers track credit card tips after tip outs by employee. This outcry was met with sympathy from Congress in the form of legislation prohibiting enforcement of IRS's proposed revenue rulings.

Congress provided that Section 6041(a) "shall be administered . . . without regard to Revenue Rulings 75-400 and 76-231, and . . . in accordance with the manner in which such law was administered before the issuance of such rulings." Tax Reform Act of 1976, P.L. 94-455, § 2111(a) (effective Jan. 1, 1976). Congress subsequently codified Section 6041(e) to clarify that the reporting requirements of that section had no applicability to tips and amended Section 6001 to clarify that the only records that the employer is required to keep with respect to tips are total credit card receipts and the employees' reports of tips to the employer pursuant to Section 6053. P.L. 95-600 § 501(b). *See* Reg. 31.6001-5(a)(16).

Congress, however, did not turn a deaf ear to IRS's concerns. In 1982, Congress enacted the tip allocation provisions of Section 6053(c), which provided IRS with more information with respect to tip income than virtually any other form of income. Tax Equity and Fiscal Responsibility Act "TEFRA," P.L. 97-248 § 314(a). Specifically, when all employees in a restaurant fail to report collectively at least 8% of food and beverage sales as tips, Section 6053(c) requires the employer to report the aggregate shortfall to IRS and to allocate the shortfall among the directly tipped employees in the proportion that each employee's sales or hours worked bears to total sales of the establishment or total hours worked by all such employees. This allocation is also required to be reported on each employee's W-2 form. The allocated tips *must* be reported on the employee's income tax return unless he has a daily record which will establish that the allocated tips were not earned. IRS Publication 531.

In addition, Section 6053(c) requires restaurants to annually file Form 8027, informing IRS of the restaurant's gross receipts, aggregate amount of charge receipts, aggregate amount of charged tips shown on the receipts, and total tips reported by the employees. *See* J.A. pp. 38-39. Once again, however, Congress refused to require the employer to be involved in ascertaining the veracity of employee tip reporting. Section 6053(c) did not shift the responsibilities for reporting from the employee to the employer; nor did it shift the responsibility for monitoring, auditing, and enforcing employee compliance from the IRS to the employer. Rather, the provision was enacted "in order to assist the [IRS] in its examination of returns filed by tipped employees," and the employer's

responsibility was limited to the provision of information for purposes of assisting IRS in doing its job. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 556-8, reprinted in 1982 U.S.C.C.A.N. 1328-30.

When Congress enacted the tip allocation provisions, it also required the Treasury to conduct a study on tip compliance in the industry. TEFRA sec. 314(c). When the study was finally released in late 1990, the Treasury recommended that (1) the allocations threshold be increased to 10% of gross receipts; (2) employers be required to verify that employees report as income all tips they receive on credit card charges; and (3) the allocation provisions be extended to small establishments. None of these proposals was enacted by Congress. Research Division, Internal Revenue Service, Pub. 1530, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984*, Catalogue No. 12482K, Study Conclusion p. i.

In 1987, in order "to apportion the costs of Social Security benefits more accurately," Congress amended Section 3121(q) to subject "all tips which are *credited for benefits purposes*" (rather than just those used to satisfy the employer's minimum wage obligations),[3] to the employer share of FICA.[4] IRS's interpretation of this

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[3] *See* Staff of Senate Committee on Finance, 100th Cong., 1st Sess., S. Prt. 100-63, Explanation of Provisions Approved by the Committee on December 3, 1987, for Inclusion in Leadership Deficit Reduction Amendment 203 (Comm. Print 1987) (emphasis added).

[4] *See* Omnibus Budget Reconciliation Act of 1987 (OBRA), Pub. L. No. 100-203, § 9006(a), 101 Stat. 1330, 1330-288 (effective

provision as permitting an assessment for an employer's share of FICA taxes based upon a determination of the tip income of all employees collectively is at the heart of much of the controversy in this case.

Commencing in 1993, six years after Section 3121(q) was enacted, IRS began threatening to assess the employer share of FICA taxes based on the gross estimated tips of all employees, without any determination of the employees' individual tip earnings, for each of the years since the amendment of Section 3121(q).[5] The threat of such an assessment effectively forces the employer into undertaking obligations for, verifying, investigating, monitoring, and policing compliance by its employees – responsibilities which Congress and the Courts have considered, evaluated, and steadfastly refused to transfer from IRS to the employer.

IRS presented restaurateurs with a Hobson's choice: potential assessment for employer FICA taxes on an aggregate estimate of unreported tips of all employees collectively, against which employers would have no defense in the absence of the necessary employee information as to actual tips received,[6] *or* participation in IRS's

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Jan. 1, 1988), amending 26 U.S.C. § 3121(q) (and repealing § 3121(t)).

[5] IRS's position is that the statute of limitations does not begin to run until a notice and demand is issued because not until that time is there a liability for the tax. *See* Pet. App. 11a, 12a, 42a, Rev. Rul. 95-7 1995-1 C.B. 482 and IRS Field Service Advice Memorandum 1998-468.

[6] This assessment could easily amount to twice a restaurant's annual profits. Industry profits are approximately

tip compliance program. The heart of the tip compliance program is the employer's "voluntary" cooperation in effectively forcing employees to report tips at an average aggregate percentage of sales through a Tip Rate Determination Agreement ("TRDA"). Although the Treasury Department had found that the nationwide average tip rate is 11.9% of gross sales and varies greatly, *see Tip Income Study*, p. 3, the IRS at a recent industry presentation disclosed that it is seeking to bring employee tip reporting up to 14½% of an establishment's gross sales.[7]

Under TRDA, the employer is responsible for enforcing reporting at the set rate by at least 75% of its tipped employees, monitoring continued reporting by its employees, and policing the filing of federal income tax returns by its employees. IRS agents have reportedly suggested that employers withhold paychecks of employees who refuse to participate, lock tips in a lock box until reported, or require servers to sign TRDA as a condition of employment in order to assure tip reporting at the IRS-determined rate.[8] In addition, the employer

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4% of sales (*See* brief of *Amicus* National Restaurant Association). An assessment for estimated unreported tips equal to 7% of sales for all years since 1988 would equal 7.5% of sales or nearly twice average annual profits (7% X 7.65% FICA X 14 years).

[7] Speech of Tony Worchalak, Director of the Office of Employment Tax Administration and Compliance for the Internal Revenue Service, before the American Payroll Association's Hospitality Payrolls Workshop, April 14-16, 1994.

[8] "The Tax Man," by John McLaughlin, *Restaurant Business Magazine*, October 10, 1994. It should be noted that many of these suggestions would violate various Federal and State Wage & Hour Laws.

must report to IRS the names, social security numbers, wages paid, shifts worked, hours worked, job classifications, and charged tips paid, as well as any other information deemed necessary by IRS. All this notwithstanding the fact that the employer is not legally required to maintain such information and regardless of whether the employer has a payroll information system for separating and identifying the information demanded by IRS. *See* brief of *Amicus* American Gaming Association ("AGA").

When the first few aggregate assessments were issued under TRDA, the industry docketed its first case in court and again turned to Congress for relief. In response, Congress enacted Section 45B in 1993. This provision allows employers to take a dollar-for-dollar income tax credit for FICA taxes paid with respect to employee tips in excess of those treated as wages for the minimum wage requirements.[9] The Section 45B credit had the effect of negating for many taxpayers the threat of the assessments here in issue.

Not easily deterred, less than 6 months after Congress enacted this strong rebuke to IRS's TRDA program, IRS promulgated a regulation limiting Section 45B's credit to taxes paid with respect to tips actually reported by the employee to the employer as required under Section 6053(a). Treas. Reg. § 1.45B-1T (26 C.F.R.). The Treasury reasoned that this restrictive interpretation of Section

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[9] *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13443(a), 107 Stat. 312, 568. *See also* Highlights and Documents, March 4, 1994 pp. 3913-3920 for a complete discussion of the purpose, intent, and history surrounding Congress's passage of 45B credit.

45B "provide[d] employers with a strong incentive for encouraging employees to report their tips." March 30, 1994 Letter from Assistant Treasury Secretary Samuels to Senator Lott.

Congress once again responded by countermanding IRS's action. Initially, 64 members of Congress, in a letter to Secretary of Treasury Lloyd Bentsen, made clear that the employer was not responsible for what the employee reports: "The IRS has cited 'Congressional intent' as the reason for restricting the FICA tax credit. This position has no basis in the statute or the conference report language." Highlights & Documents, March 4, 1994 at 3913. Congress ultimately followed up, in 1996, by codifying its disapproval of the Treasury's limitation on Section 45B's credit, thereby refusing to penalize employers if their employees failed to report all of their tips. Congress amended Section 45B to clarify that the credit is available with respect to employer FICA taxes paid on all tips, "without regard to whether such tips are reported under section 6053."[10]

Meanwhile, a compromise agreement between IRS and restaurant industry representatives was negotiated. The agreement afforded some protection to the industry

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[10] *See* I.R.C. § 45(b)(1)(A), as amended by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1755, 1759; *see* H.R. Conf. Rep. No. 104-737 at 186-187, reprinted in 1996 U.S.C.C.A.N. 1677, 1678-79; S. Rep. No. 104-281 at 7-8, reprinted in 1996 U.S.C.C.A.N. 1474, 1480-83; H.R. Rep. No. 104-586 at 5-6 (1996). At the time of this amendment, the IRS was not assessing the tax in the manner it has done here so there would have been no need for Congress to do any more than it did. *See* J.A. 103-107.

while it continued to litigate the legality of IRS's interpretation of Section 3121(q) and to pursue relief from IRS's interpretation of Section 45B. Under the compromise Tip Reporting Alternative Commitment ("TRAC") program announced in June 1995, a restaurant agrees to educate its employees about tip reporting, establish procedures to ensure accurate tip reporting, and comply with all federal tax requirements. In exchange, IRS agrees to base the restaurant's FICA tax liability solely on additional tips reported by employees on their income tax returns (Form 4137) and on any unreported tips discovered during an IRS audit of an employee. While TRAC may be a far more palatable program, the threat remains of a debilitating assessment potentially exceeding twice a restaurant's average annual profits. *See supra*, at 9 n.6.

When some IRS offices used the threat of such an assessment to coerce participation in the voluntary agreement, restaurateurs once again sought congressional intervention and IRS advised the field that it was against IRS policy to threaten employer only audits. J.A. 103-107. This policy was subsequently codified. (IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering a [TRAC] Agreement.").[11] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 685, 755 (July 22, 1998).

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[11] IRS argues Congress gave tacit approval to the employer only aggregate assessments by virtue of this amendment. Congress did not give approval to what IRS had assured Congress it had discontinued in practice.

With the protection afforded by the TRAC program and the availability of an offsetting dollar for dollar credit, one may ponder Fior's motivation for continued litigation. There are several reasons. First, the threat of an assessment of an employer share of FICA taxes on unreported tips for the 14 years since the amendment of Section 3121(q) is real. One court has already held that IRS has an open-ended statute of limitations. *LIR Management Corp. v. United States*, 86 F.Supp. 2d 340 (S.D.N.Y. 2000). It will take most industry employers many years to absorb an assessment of that magnitude, even with Section 45B's credit.[12] In addition, a tax credit is of little value to those employers in a precarious financial situation or with loss carry-forwards. A restaurant that barely breaks even does not owe enough in taxes for a tax credit to be of much assistance.

Most importantly, the greatest concern always has been, and continues to be, the industry's employees. The simplest way for the small restaurant employer, entitled to a dollar-for-dollar credit, to protect itself from an IRS threat of a financially devastating tax assessment is to find a way to force its employees to report at the level IRS seeks. Satisfying IRS's stated goals of average industry tip reporting at 14½%, when industry statistics indicate the actual figure is substantially less, will inevitably mean that many employees will be required to report more in tips than they actually earn, making their effective tax

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[12] Annual taxes at an estimated 30% of annual profits of 4% equals 1.2% of sales. It would take more than 6 years before the 45B credit would fully offset a potential FICA tax assessment on tips equal to 7.5% of annual sales. *See supra*, at 9 n.6.

rate one of the highest in the country. This, the restaurant employer wants no part of.

This case. Since the inception of this case, IRS has implied that Fior knew that its employees were not reporting the full amount of their tips and that Fior had an option to pay its employer share of FICA on an amount greater than the amounts reported to it by its employees. *See* for example, Gov. Brief before the 9th Cir. Filed 8/26/99 pp. 13, 33. Neither is correct.

Fior's employees receive tips on a *daily* basis either table-by-table as the patron departs or at the end of the employees' shifts when they "cash out." Tips are shared with indirectly tipped employees, for example, hostesses, busboys and bartenders, with the balance "pocketed." J.A. 60. *See* AGA brief. Fior's employees report their pocketed tips to the employer at the end of every *biweekly* payroll period throughout the year, in accordance with the requirements of Section 6053(a).[13] These amounts are processed for payroll purposes along with the employees' hourly wages, and the required FICA and withholding amounts are withheld and deposited by Fior.

Fior subsequently provides a reconciliation or accounting of such payments and collections to IRS on a *quarterly* basis using Form 941. Reg. 31.6011(a)-1, Reg. 31.6302-1. J.A. 80-88.[14] In accordance with the instructions

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[13] Reg. 31.3121(q)-1(c) provides that only tips retained by an employee are to be reported by him. The monthly liability reconciliations on Forms 941, J.A. 80-88, correspond with the bi-weekly payroll periods.

[14] Contrary to the Government's assertion (G.B. 20), the filing of Form 941 does not "impose" any taxes. The Form 941 is

on Form 941 and the mandate that the employer's Form 941 "return shall include wages received by an employee in the form of tips *only* to the extent of the tips reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a)," Reg. 31.6011(a)-1(a) (emphasis added),[15] Fior included on its Form 941 for both the employer's and employee's share of FICA only those tips reported to Fior by the individual employee. As is evident from the instructions to Form 941 and the Form itself there is no practical or legally authorized way for Fior to have included an additional amount of estimated tips (*i.e.*, the total credit card tips) for purposes of the employer share of FICA alone.

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merely an accounting of tax deposits already made. The inclusion of amounts on Form 941 is not coterminous with or even evidence of a liability for a tax imposed. Income and employee FICA taxes withheld, along with the employer's FICA deposits, are included in the lump sum total figures on the form (*see* lines 5, 6a, 6b, 7 and 11). Obviously, no tax is "imposed" on the employer for those amounts. The employer responsibility is only to collect these amounts. Similarly, the total figure may be adjusted by a variety of things, such as adjustments from other quarters and employee earned income credits. Form 941 therefore tells one nothing about the taxes imposed. It is the actual *payment* of the wages to the *individual* employee, not the subsequent commingling of it with other wage payments and accounting for it on Form 941, which triggers a tax liability and upon which the tax is *imposed*.

[15] *See also* IRS Field Service Advice Memorandum 1998-74 (holding that an employer is *prohibited* from filing an amended return or an adjustment on Form 941 even for amounts of unreported tips which the employer may have a reasonable basis for concluding the employee received (*i.e.*, as in the case of allocated tips or tips on credit card receipts), until such time as the Service sends a Notice and Demand).

No sales information is included on the Form 941 and no comparison to sales is made on the Form.[16]

In January of the subsequent year, Fior transposes the amounts of individual wage earnings, social security earnings, and tips reported onto individual employee W-2 statements and W-3 transmittals to the Social Security Administration ("SSA"). The employer is required to reconcile the amounts on the W-2's, W-3's, and the quarterly Form 941 filings throughout the year. Section 12 of IRS Publication 15 (2000) Circular E.

Two months after the close of the year, Fior compares its annual sales data with the total biweekly payroll data and completes and files Form 8027, providing IRS with the total amount of gross receipts, charged receipts, charged tips, and total tips reported. It was this form that revealed that Fior's employees had collectively reported less than the total amount included in the tip box on the credit card receipts. The difference led to an IRS tip compliance check whereby IRS used Fior's credit card charge slips to determine a tip percentage for the charges and then applied that tip rate to Fior's gross receipts to estimate an aggregate amount of the tips received by all of Fior's employees collectively. IRS then sent Fior a Notice and Demand for the employer share of FICA tax

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[16] In addition, payroll is often handled throughout the industry by outside payroll services who are not privy to sales data. Even when handled internally, payroll processing systems are separate and distinct from other accounting and financial systems and functions. *See* AGA brief.

on the difference between this aggregate amount and the amount of tips reported by all of its employees.

In doing so, IRS did not determine how much, if any, of the aggregate unreported tip income was tip income received by an individual employee amounting to less than $20.00 a month.[17] *See* 26 U.S.C. 3121(a)(12). Nor did IRS determine how much of the aggregate unreported tip amount was received by individual employees which, when added to such individual employee's other wages paid by the employer, exceeded the wage base and was therefore not taxable. *See* 26 U.S.C. 3121(a)(1). Nor did it determine how much of the aggregate unreported tip amount was received by individual employees in excess of the federal minimum wage, for which the employer is entitled to a Section 45B tax credit. *See* 26 U.S.C. 45B. Moreover, the aggregate amount of all employees' tips collectively tells nothing about the amount of tips retained by individual employees after tipping out, a practice which typically reduces a directly tipped employee's amount of tips retained by up to 25%. *See* J.A. at 60-62. *See also* AGA brief.

IRS also made no attempt to ascertain whether the gross receipts upon which it based its calculation included "carry-out" sales or "employee meals," which are often included in a restaurant's gross receipts but

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[17] IRS considers this issue "marginal." G.B. 36 n.26. IRS fails to recognize that the restaurant business is a very transient business with employee turnover rates as high as 200 to 400%. For some job categories, such as busboys and dishwashers, the turnover rate could be even higher with job slots repeatedly filled with those literally "here today, gone tomorrow."

upon which tips are seldom received. Nor did IRS attempt to determine the restaurant's policy with respect to "stiffs" or "walk-outs," which are often included in gross receipts for financial purposes then expensed, but upon which tipping is unlikely as IRS's own statistical evaluations have found. *Tip Income Study*, 4. Nor did IRS attempt to determine whether there existed any special methods of operation, such as a buffet, which would result in a different tip rate for certain sales.

IRS does not even know whether the amount designated as a tip on a charge receipt was in fact a tip. For example, IRS does not know to what extent customers use the tip line to procure cash to purchase cigarettes or to pay for valet parking or, as in some establishments, to feed video games – information which can obviously only be procured from the employee himself. IRS does not know whether charged tips were turned over to employees net of the credit card fees often charged by many employers, or whether the aggregate tips reported on Form 8027 included credit card amounts which were uncollectible for which the employer sought reimbursement from the employee.

Significantly, the documents supporting the Notice and Demand to Fior did not follow the Internal Revenue Manual directions, as is required for all tip compliance examiners in making determinations of additional taxes due. *See* Employment Tax Handbook of the Internal Revenue Manual "I.R.M.," section 4.23.7.13 (providing uniform employment tax audits instructions to IRS personnel). Specifically, the documents were not accompanied by direction to Fior that "Forms W-2 or W-2c must be issued to the employees." *See id.*, section 4.23.9.9.3. The

number of employees whose W-2's should be amended was not noted on the form as required. *Id.* Nor was the required reconciliation between FICA wages on Form W-3 or W-3c and FICA wages on Form 4468 performed by the auditor. *See id.*, section 4.23.9.10. The standard language on Form 4468 required by IRS procedures to be used in every employment tax audit was curiously omitted from the form used for this assessment.[18] Accordingly, no wage earnings history records for social security benefit computation purposes were, or ever can be, credited for the tip earnings the employees allegedly received.

In short no individual employees were identified, no individual tip earnings were determined, no W-2's were asked to be amended, and the SSA received no notification of an adjustment to individual employees' wage earnings history records despite the clear direction in the Internal Revenue Manual that these procedures are required in every employment tax audit. Instead, the tax was based solely upon the aggregate tip earnings of all employees collectively.

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[18] This language provides that "Under IRC sections 6051 and 6071 and the regulations under those sections, you are required to furnish Form W-2c (Statement of Corrected Income Tax Amounts) . . . to each of the ___ employees whose wages are adjusted by this report. Also you are required to file the original of these statements with Form W-3c [for transmittal to the SSA]."

SUMMARY OF THE ARGUMENT

This case is part of a long-running struggle between the IRS and the restaurant industry over the uncertainty inherent in accurately determining employee tip income. For more than 30 years, the IRS has attempted repeatedly to implement provisions that work in various ways to shift to employers the burden of accurately determining the tips received by their employees. Every time it has done so, however, the Congress has intervened and clarified that it is the job of IRS, and not of the employers, to police the accurate reporting of income by employees.

This case is simply IRS's latest re-invention of its efforts. This time, IRS asserts an authority to impose a tax upon employers based upon an aggregate estimate of total tip income received by all employees without ever inquiring into the individual instances of particular employees, or making any effort to determine the accuracy of their individual tip reports. IRS claims an inherent authority to advance such a gross approximation of total tips, and shift to the employer the burden of proving both its inaccuracy, and the total correct amount. If successful in this endeavor, IRS will have accomplished what Congress has denied it for decades – the right to make employers either take responsibility for tracking the tips received by its employees, or suffer the penalty of an inflated assessment advanced by the Government for their failure to do so.

Such a result must be rejected because the language, context and history of FICA tax provisions require the tax to be based upon determinations of individual employee tip earnings. It is simply impossible to administer the

FICA tax provisions of the code otherwise. The FICA tax is imposed on employees and employers, by Sections 3101 and 3111, based on the wages earned by individual employees. Both sections refer to the exact same definitional sections for determining what constitutes "wages" subject to the tax. When Section 3121(q) was amended in 1987 to subject all tips received to the employer share of FICA tax, the additional employer taxes were expressly conditioned upon a finding that the individual employee failed to report his tips. Congress also tied the employer's liability to a specific enforcement procedure – the issuance of a notice and demand – which as a result of, by regulation and longstanding agency custom and practice, entailed the determination and adjustment of individual wages earnings and the crediting of social security earnings histories for such earnings.

Further, assessing employer FICA tax on the basis of an aggregate assessment of the tip income of all employees would effectively nullify a number of statutory provisions. Without determination of the tip earnings of individual employees, employers would be unable to take advantage of both Section 3121(a)'s adjustments which may reduce the amount of tips which are actually considered "wages" subject to FICA taxation and Section 45B's credit for FICA taxes paid by an employer for tips in excess of the minimum wage.

Perhaps most importantly, the claimed authority to impose employer FICA taxes by means of aggregate assessments would frustrate the very purpose of FICA tax – to provide individuals with protection under the social security system. Congress made wages earned the basis for determining the benefits ultimately to be

received. If IRS were authorized to assess an employer's FICA tax without making a determination of the income received by that employer's individual employees, it would be impossible to credit those employees to get wage earnings credit for such tips. Moreover, assessing employer FICA taxes on tip income while failing to credit employees for tip earnings distorts FICA into a general welfare tax and provides a windfall for the Government.

Notwithstanding this individual focus, IRS purports to have authority under Section 6201 to assess employer FICA taxes based on an aggregate estimate of the tip income earned by all employees collectively. But Section 6201 does not give IRS the power it claims. Unable to cite any authority for that proposition, the Government instead argues by analogy to Section 446(b), which has been construed as authorizing IRS, in the income tax context, to impose tax assessments based on estimates where individual taxpayers have not kept their own appropriate records from which income can be determined. The argument is unpersuasive because Fior, unlike the taxpayer subjected to assessment under Section 446, has kept all appropriate records and is in no way at fault for reporting the amounts reported to it by the employee. Indeed, under the law, it had no choice but to do so. Moreover, if Section 6201 conferred a general power to levy assessments by estimate, even absent taxpayer fault or failing, then Section 446(b) would be wholly redundant and unnecessary.

The legislative history of the FICA provisions further demonstrate that Congress intended employer FICA tax to be based upon determinations of individual employee tip earnings, and not an aggregate estimate which is

demonstrably inaccurate in many ways, but which the employer must live with unless he can come forward with a more accurate number. For the past thirty-plus years, IRS has repeatedly attempted, in varied and creative ways, to shift the burden of determining tip income to employers of tipped employees. In response, Congress has repeatedly rejected IRS's attempts to place this onus on employers, affirming that the admittedly difficult job of determining unreported tip income rests not with the employer, but with IRS.

Not only is IRS's claimed aggregate assessment authority without basis in the statute and contrary to the legislative history, it has no basis in sound tax enforcement policy either. IRS has ample avenues open to it to address the problem of under-reporting of tips by employees. Indeed, it appears that by utilizing those tools, IRS has already made an appreciable impact on the tip under-reporting problem. To the extent the problem remains significant, the aggregate assessment method is hardly a solution. It leaves unpaid about 75% of the taxes associated with tip under-reporting – both the employee's share of FICA and the employee's income taxes. Indeed, in view of the tax credit provision of Section 45B, profitable restaurant employers will receive a one-for-one credit for the FICA taxes paid for tips in excess of the minimum wage, leaving only unprofitable restaurants significantly impacted financially by the aggregate assessment method that the Government says is so important.

Even if the language, context, and legislative history of the FICA tax provisions did not clearly demonstrate Congress's intention that an employer's FICA tax be

based upon a determination of the tip earnings of individual employees, no deference would be owed to IRS's current construction of the FICA provisions. IRS's construction is nothing more than its current litigating position, for which it has no long-standing reasoned explanation or promulgation in support. In fact, IRS documents discussing the proper method for assessing an employer's FICA tax unanimously agree that this tax should be based upon determinations of individual employee tip earnings.

ARGUMENT

IRS DOES NOT HAVE AUTHORITY TO BASE EMPLOYER FICA TAXES ON AN AGGREGATE ESTIMATE OF THE TIP INCOME OF ALL EMPLOYEES COLLECTIVELY

Congress imposed an employer FICA tax on the tip earnings of *each* individual employee, not the gross tip earnings of all employees *collectively*. The employer FICA tax is a tax on the exact same thing as the employee tax: the "wage" earnings of each individual employee. In both instances the "wages" subject to the tax must be established by a determination of individual employee earnings. It is not possible to administer the FICA tax provisions of the Code consistent with the statutory language, framework, and purpose otherwise.

A tax imposed on the remuneration of all employees collectively as opposed to a tax on the total wages paid to each individual employee is not a distinction without a

difference.[19] A tax on the aggregate earnings of all employees collectively is not just a matter of the wrong amount or the wrong means of reaching the amount due – it is a tax on the wrong "thing" altogether. Since the employer is not liable for a FICA tax on an aggregate estimate of the tips received by all employees collectively, but a tax on the tip "wages" of individual employees, Fior did not dispute the facts or determinations used to tax the aggregate unreported tip income for purposes of summary judgment, but instead challenged the *entire* assessment. Pet. App. 39a; J.A. 25-26.[20]

A. Congress Intended The Employer FICA Tax To Be Based Upon A Determination Of The Tip Earnings Of Individual Employees

The fact that Congress intended that the employer FICA tax be based on the wage earnings of *each*

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[19] In this regard, IRS is wrong when it suggests an estimate based upon the average tip rate and gross sales of the restaurant is far more likely to achieve factual accuracy than individual audits. For instance, if an employer has two employees, one who made $75,000 and the other $25,000 a tax based on an estimate of gross wage earnings would be imposed on $100,000. On an individual basis, with a FICA wage base of $55,500, the employer share of FICA would be based on $80,500 ($55,500 + 25,000).

[20] In addition, Fior challenged the assessment on constitutional grounds: (1) the constitutional provisions relating to uniformity and equality of taxation have been violated by IRS's singling out employers of tipped employees for the denial of earnings credits; and (2) the application of an estimation method against one who has complied fully with the law raises due process concerns. J.A. 26.

individual employee rather than on the aggregate wage earnings of all employees *collectively* is manifest in the statutory provisions, the statutory scheme, and the legislative history behind them. *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126 (1934). ("The true meaning of a single section of a statute in settings as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.").

1. The Statutory Language Imposing The FICA Tax Requires That It Be Determined Based Upon The Taxable Tips Of Individual Employees.

In ascertaining the intent of Congress the court starts, as it must, with the language of the section. The language of the operative FICA sections is consistently focused on the individual. Both Sections 3101 and 3111 impose a tax *"equal to the following percentages of wages (as defined in section 3121(a))* . . . with respect to employment (as defined in section 3121(b)) . . . " (Emphasis added.) Section 3121(a) provides that " . . . the term 'wages' means all remuneration for employment . . . except" 21 enumerated exceptions which must be determined based on each individual employee's specific compensation package. Section 3121(q) provides: "tips received by *an* employee shall be considered remuneration for such employment."

While the tax on the employee is an income tax, the tax on the employer is an excise tax on the employment relationship. *Helvering v. Davis*, 301 U.S. 619, 645 (1937).

The employer's share of the FICA tax is triggered not merely by entering into an employment relationship, however, but by the *payment of wages* in the context of that relationship. Reg. 31.3111-3. An employer does not pay wages to all employees collectively, but pays wages to *each* employee *individually*. The employer's liability for FICA taxes therefore attaches to *each* of these individual payments, not when they are later summed and reported, as the government argues. GB. 19-20.[21] Since it is the *payment* of wages to the *individual* employee which triggers the tax, the FICA statute defines "wages" subject to the employer and employee taxes identically.

Sections 3101 and 3111 both impose a tax on the exact same thing: *"wages as defined in section 3121."* In this case that means "tips received by an employee," Section 3121(q), whether reported to the employer or not, and as adjusted by Section 3121(a), are subject to both the employer and employee FICA tax. In the context of the employee FICA tax, this provision clearly refers to the *individual* employee's tips, since the employee cannot be taxed under Section 3101 on anything but his own tips. Since Sections 3101 and 3111 both refer to the same definitional section, the employer FICA tax provision must also refer to the tips received by that individual employee. *See Sullivan v. Stroop*, 496 U.S. 478, 484 (1990)

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[21] The government suggests that the fact that an employer does not account for and is not "assessed" FICA tax separately for each employee is indicative of the fact that the tax is not *imposed* upon individual employee earnings. This conclusion is not warranted. An "assessment" does not create the liability but merely acts as a judgement for taxes found due. *Bull v. United States*, 295 U.S. 247, 259 (1935).

("Identical words used in different parts of the same act are intended to have the same meaning."); *Rowan Companies v. United States*, 452 U.S. 247 (1981) ("It would be extraordinary for a Congress to intend, without ever saying so, for identical definitions to be interpreted differently.").

Moreover, a construction of Section 3111 as imposed upon "employees' aggregate tip income" cannot be consistently applied. When an employee reports his tips the section would be construed as applying to the tips of an individual employee; when he fails to report, IRS would construe the tax as applying to all tips of all employees collectively. Section 3111 cannot be read as imposing a tax on tips of all employees collectively some of the time, and a tax on individual employees at other times. The tax is imposed on the tips received by each individual employee all the time.

Such a conclusion is reinforced by consideration of the 1987 amendments to Section 3121(q) subjecting all tips received to the employer's portion of the tax. The amendments conditioned the employer's liability for FICA taxes on unreported tips on inaccurate or incomplete employee tip statements. Such statements are not prepared by all employees collectively but by each employee individually.

Congress's also conditioned the tax upon the issuance of a "notice and demand" as opposed to some other event. This requirement is an unequivocal indication of Congressional intent that the tax be imposed upon a determination of individual tip earnings with credit to the SSA records of individual employees for such tip

earnings. A "notice and demand" is a term of art with a clear procedural path to be followed before its issuance. For every employment tax audit of an employer, the Internal Revenue Manual directs the auditor to require the employer to prepare and issue corrected W-2c's showing the exact amount of any additional "wages" determined on each individual employee's W-2c. The employer is further directed to transmit each of these corrected W-2c's to the SSA for wage history benefit purposes. The auditor is directed to prepare Form 4668 Employment Tax and Examination Changes Report and to "insert the number of employees whose Forms W-2 should be amended by filing Forms W-2c on Form 4668." The auditor is instructed to reconcile the FICA wages on the corrected W-2c's with the adjustments on his report. If the corrected forms cannot be obtained from the employer, the auditor is directed to "attach a list of employees who should receive wage statements to Form 4668." *See* I.R.M. 4.23.2.13 and 4.23.9.9-10. Regulation 31.6051-1(c)(1)(ii) requires these procedures and the correction of employees' W-2s. For unagreed cases the reports (Forms 4668 along with others) will be sent to the employer with a preliminary (30-day letter). I.R.M. 4.23.9.11.2. If the matter remains unagreed a "notice and demand" will issue.

These are the procedures to be followed in all audits. When Congress amended Section 3121(q) to provide that an employer would be liable for the tax when "notice and demand" is issued, Congress intended the employer

share of FICA taxes on unreported tips be determined by application of these procedures.[22]

2. This Conclusion Is Confirmed By Other Provisions Of FICA.

Even if the above statutory provisions did not have "a dispositively plain meaning," *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001), Congressional intent is not manifest in the words of the statute alone. The fact that an assessment based on an aggregate estimate of the tip earnings of all employees collectively conflicts with other FICA provisions and renders them meaningless is further evidence that Congress intended FICA taxes to be based upon determinations of individual wage earnings.

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[22] The fact that the statute imposes the employer's share of FICA taxes on an employee's tips when the employee fails to report them and that such taxes can be assessed separate from, at a later date than, and regardless of whether the employee is audited, assessed, or even pays the tax, does not support a construction of the statute as imposing the tax on tips received by all employees collectively as IRS argues. G.B. 4, 8, 15, 16, 17, 19, 20.

The timing of the employer's obligation to pay the tax under Section 3121(q) (*i.e.*, when a notice and demand issues) does not re-characterize it as one imposed on tip earnings of all employees collectively. To the contrary, a proper reading of the statute is that when Fior is provided a "notice and demand" for FICA taxes on additional tip earnings of an individual employee (either as reported by the employee on Form 4137 with his income tax return or as adjusted after an IRS audit of the individual tipped employee), Fior owes the tax, and the fact that the employee has not been audited, assessed, or paid his share does not relieve Fior of its liability to pay.

Section 3121(a) provides that 21 exceptions may apply to determine what amount of an individual employee's "remuneration" is actually "wages" subject to FICA taxation. *See* Section 3121(a)(1)-(21). Those adjustments include, for example, exclusion from "wages" for amounts received by an employee in excess of the contribution and benefit base and below $20.00 per month in tips. These adjustments, along with the 20 others, must be computed on an individual, employee-by-employee basis and cannot be computed in the aggregate. They would therefore be eliminated under a determination of wages in the aggregate. *See* Treas. Reg. §§ 31.3121(a)(1)-1(a)(2) and 31.3121(q)-1(d). Section 3121(a)'s adjustments cannot possibly be given effect in any context but the determinations of individual earnings – a clear indication of Congressional intent that the tax be determined on an individual basis.

Nor can Section 45B be given effect without determination of the tip earnings of individual employees. Section 45B provides a credit for FICA taxes paid on tips of an employee in excess of the minimum wage. Obviously, a determination of amounts in excess of the minimum wage must be on an individual basis.[23] "An

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[23] IRS misunderstands the district court's holding with respect to the 45B credit. The 1996 amendments to the 45B credit were enacted for the specific purpose of providing a credit for tips which employees fail to report to the employer. However, the operative language of 45B provides a credit for FICA taxes paid on tips "received by an employee". If a notice and demand is issued in the aggregate, the FICA taxes are not paid "with respect to tips received by an employee," once again defeating the very purpose of the statute.

employer cannot take advantage of this tax credit if the IRS assesses his FICA taxes on unreported employee tips in the aggregate." Pet. App. 47a. As the district court below stated:

> Sections 3121(a) and 45B therefore indicate that Congress intended that individual wage assessments would be made before the employer's share of FICA taxes could be assessed. . . . [Otherwise], those credits and exemptions would become a nullity for many employers. It is a basic rule of statutory construction "that one provision should not be interpreted in a way . . . that renders other provisions of the same statute inconsistent or meaningless."

Id. 48a (citations omitted).

3. Allowing IRS Authority To Proceed By An Aggregate Estimate Of Employees' Tips Will Frustrate FICA's Core Purpose Of Securing Employee Benefits.

An aggregate assessment based upon the tip earnings of all employees collectively is also inconsistent with the FICA statute's core purpose of providing retirement income security because an aggregate assessment denies individual employees wage earnings history credits for such tips. If wage determinations for individual employees are not made a part of the process of adjusting the amount of FICA tax owed by an employer, notification cannot be sent to the SSA of the additional tip earnings for purposes of crediting the wage earnings histories of individual employees for future social security benefit purposes.

Congress's purpose in subjecting tips to FICA in the first place was to provide "better protection under the social security program for more than a million [tipped] employees and their dependents." H. R. Rep. No. 213, *supra*. This purpose did not change when Congress decided that "in order to apportion the cost of social security benefits more accurately, employers should be subject to tax on all tips *which are credited for benefit purposes.*" Senate Committee Report 100-63 at 203 (1987) 133 Cong. Rec. S34,826 (1987) (emphasis supplied). While it is not intended that benefits should be measured exactly by the amount of payments, the underlying scheme is based upon the general relationship of the benefits to the wages earned and the taxes paid thereon. *Mathews v. de Castro*, 429 U.S. 181, 186 (1976); *Flemming v. Nestor*, 363 U.S. 603, 608 (1960).

The amount of the monthly benefit to which an individual is entitled is directly related to the "average monthly wage" as reflected in the "wages records" which the Treasury Secretary is required to maintain. 42 U.S.C. 405(c). If the wage records of the individual fail to reflect the receipt of covered earnings or wages, no ensuing benefits will be accorded. When individual earnings are not determined and individual wages earnings histories not credited, the assessment, as the lower court found "amounts to a tax on the employers without a commensurate benefit to the employees . . . and operates as a general revenue tax for the government beyond the purpose of FICA taxes." Pet. App. 46a. But the basis of an employer FICA tax on wages is to pay the cost of the social security benefits reasonably anticipated for the individual employee of that employer. The purposes of

the employer and employee FICA taxes are identical – to provide one-half each of the cost of social security benefits to which an identified individual employee may become entitled. *See* Testimony of J. Roger Mentz, Assistant Treasury Secretary for Tax Policy, before the House Ways and Means Committee on the President's fiscal year 1988 revenue initiatives (The amendment to 3121(q) "follows the general structure of Chapter 21 [concerning FICA] that requires an equal tax to be paid by both parties. . . . ") News Release, Doc. 87-598, Feb. 4, 1987.

If Congress had intended a different purpose for employer social security taxes, for example, to finance welfare programs or social security benefits generally, there would be no need for the 21 exceptions from employer payroll taxes available under Section 3121(a). That Congress intended that employer FICA taxes on unreported tips to be based upon a determination of tip earnings of individual employees with credit to the SSA records of those individual employees for such tip earnings is the only interpretation consistent with the statutory purpose of providing social security protection.[24]

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[24] IRS argues that employees have waived their entitlement to wage earnings credits. This argument ignores the fact that not only employees but society as a whole has an interest in its working citizens receiving social security protection. Further, it appears that employees may be denied wage earnings credit even if they do ultimately report to IRS the correct amount of tips received. According to SSA correspondence from 1993, such credits will be recorded only where the employer files the corrected amount on a Form W-2c, J.A. 70, and in this instance that can only occur where the employer receives information from IRS indicating the corrected tip figure for the individual employee. *See* discussion *supra* pp. 19, 30.

Congressional intent has been clearly and unambiguously expressed through the words of the statute, the statutory scheme, and the articulated purpose of enacting the Social Security Act and subjecting tip income to social security coverage. Since "Congress has directly spoken to the precise . . . issue," to wit, that the employer FICA tax is to be based upon a determination of the tip earnings of each individual employee, "that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 842 (1984).

B. Sections 6201 And 446 Do Not Provide Authority For IRS To Determine Employer FICA Taxes Based On An Aggregate Assessment Of Employee Tip Income

Notwithstanding the individualized nature of the employment tax provisions of the code, IRS argues that Section 3111 nonetheless imposes a liability for employer FICA tax on all tips received and asserts its broad based authority under Section 6201 to collect it by means of an aggregate assessment. Since the language of Section 6201 cannot itself reasonably be read to confer such authority, IRS argues by analogy to Section 446(b) that assessing an employer's FICA taxes based on an aggregate estimate of the tip earnings of all employees collectively is permissible. Section 446 is not analogous however, and Section 6201 cannot confer authority to IRS which is specifically negated elsewhere.

Section 446(b) has been interpreted to allow IRS to estimate an individual employee's income for income tax purposes if that employee has not kept proper records of tip income and there is therefore no way to determine precisely the amount due. Because tipped employees themselves are responsible for any inadequacy in their tip income records, courts have held that the IRS's use of estimates under this section is justified. *See Mendelson v. Comm'r*, 305 F.2d 519 (7th Cir. 1962) ("Obviously, where a taxpayer keeps no records disclosing his income, no method can be devised which will produce an exact result."); *McQuatters v. Comm'r*, 32 T.C.M. (CCH) 1122, 1125 (1973) ("In the absence of adequate record keeping by petitioners, [the IRS] was justified in reconstructing their tip income by an indirect method. . . . "). Although Section 446 applies to income taxes and does not give the IRS power to estimate FICA taxes, it illustrates the balance Congress has chosen to strike – an estimated method of assessing income may be used in the income tax context if the taxpayer himself has failed to maintain adequate records, caused them to be destroyed, or is somehow at fault in a way that prevents the IRS from making an accurate determination of income.

Even then, the faulty taxpayer is never denied the chance to adjust IRS's result. Thus, for instance, in *McQuatters*, the court held that a flat rate approach was appropriate *only* after concluding on the basis of testimony from the individual waitresses that there were not significant variations in the services performed which would result in differences in individual amounts of tip income. In addition, the court reduced the flat rate percentage by nearly 20% from that proposed by IRS to

account for many factors raised by individual employees.[25] Here, without personal knowledge of the tips received, Fior, which did everything required of it under the law, is effectively denied the defenses, available to even the most culpable of taxpayers, which the court in *McQuatters* found persuasive enough to warrant a significant reduction in IRS's determination of liability.

The necessary premise and implication of the Government's attempt to analogize to the authority granted under Section 446 is that Fior has somehow acted improperly. But that is not true. Fior is not permitted to make a FICA tax payment based on an estimate drawn from credit card tips. Fior has no option to pay on an amount greater than the amount reported to it by the individual employees pursuant to Section 6053(a). Reg. 31.6011(a)-1(a) prohibits this and requires that the employer's "return shall include wages received by an employee in the form of tips *only* to the extent of the tips reported by the employee to the employer." The instructions to Form 941 preclude it and the form itself makes no provision for such an option. Accordingly, the only records the law requires Fior to keep are the employee tip reports pursuant to Section 6053(a). Reg. 31.6001-5(a)(16).

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[25] This result flies in the face of IRS's repeated assertion throughout its brief, G.B. 9, 25, to the effect that a flat rate approach or aggregate estimate is more likely to achieve accuracy than individual determinations of tip earnings. It also illustrates that while the sum of individual audits may be nothing more than the sum of individual estimates that approach could result in a materially and significantly lower figure than that proposed by IRS on an aggregate basis.

In the absence of any wrongdoing, the analogy to Section 446 fails. Section 6201 provides no general authority to determine FICA taxes based on aggregate assessments. The inappropriateness of such a procedure is highlighted by the fact that Fior is not the taxpayer who was required to maintain the records necessary to overcome IRS's estimate.

Rather than look for what does not exist in Section 6201 IRS would be well advised to consult its terms again. Section 6201 provides: "The Secretary is authorized and *required* to make the inquiries, determinations, and assessments of all taxes. . . . " What it authorizes and requires here is an inquiry into the tip income received by individual employees.

C. The Legislative History Of The FICA Statutory Provisions Demonstrates That Congress Did Not Authorize The IRS To Assess Employer FICA Tax Based On An Aggregate Estimate Of The Tip Income Of All Employees Collectively

The Government claims a power to proceed against employers for their share of FICA taxes on tips by means of a crude, top-down estimate of total employee tips, which the employer must either live with, or refute and replace with a more accurate number based on better information. But, precisely because the determination of tip income for tax purposes has long been a difficult subject for the IRS, it has many times been the focus of congressional attention and action, going back to at least 1964. Among the products of those actions, of course, are the provisions discussed in the preceding sections which

are best and most harmoniously read as requiring that the tax be administered on the basis of determinations of individual wage earnings.

Of equally great note, however, is the legislative history of congressional actions clarifying beyond doubt that employers may not be made to bear the burden of the uncertainty inherent in accurately determining employee tip income. From the beginning, Congress took the view that the "only practical way" to get accurate tip information was to "require employees to report their tips to the employer." H.R. Rep. No. 213, *supra*. In 1976, when the IRS adopted revenue rulings that would have expressly obligated the employers to determine and report all tip income, whether or not it was reported accurately by the employees, Congress enacted legislation that expressly overrode those actions. P.L. 94-455, *supra*.

In 1982, in response to IRS lobbying for greater information concerning tip income, Congress enacted Section 6053(c) for the express purpose of assisting the IRS in "its examination of returns filed by tipped employees," but flatly declined to make employers responsible for determining or verifying the accuracy of employee reports of tip income. In 1987, Congress adopted the present language of Section 3121(q), which, on the one hand, made clear that the Section 3111 tax extends to all tips received, but, on the other hand, made clear that where tips are not accurately reported, the tax is only owing upon submission of "notice and demand" by IRS, which process by both regulation and long standing enforcement practice, requires the determination and SSA crediting of wage earnings on an individual employee basis.

Congress's emphatic denial of any IRS power to shift the burden of uncertainty to the employer continued in the 1990s. In response to an outright effort to coerce employer cooperation in forcing employees to report tips at an average aggregate percentage of sales, Congress enacted a tax credit, Section 45B, which refunded, on a dollar-for-dollar basis, all employer FICA taxes paid in excess of minimum wages. When the IRS sought to negate the section's effect by conditioning it upon actual reporting of the tips by employees – and thus again incentivize the employer to police the employee reporting of tips, Congress again adopted (in 1996) legislation expressly rejecting the IRS action and making clear that the credit was available whether or not the tips had been accurately reported.

In sum, the present effort to proceed by aggregate assessment, and thus shift the burden of establishing the correct amount of employee tip income to the employer, is just the latest in a series of efforts by the IRS. The present statutory provisions, which show no sign of conferring the power that is now claimed, are just part of the story. Equally significant are the many congressional actions taken to frustrate creative IRS efforts to avoid the burden of examining the income of individual employees and shift that responsibility to the employer. For that reason, as well, this Court should affirm the decision below.

D. The Government's Argument Based On Urgent Necessity Is Unpersuasive

With no legislative grant of authority to shift the burden for determining the accuracy of employee tip reports to employers, and a strong legislative history to the contrary, the thrust of IRS's argument boils down to an assertion of convenience tantamount to urgent necessity – the IRS must be given this power because the determination of tip income is a knotty problem that cannot be adequately addressed in any other way.

The Government thus comes before the Court hat-in-hand, begging the Court's forbearance lest it be unable to do its job of collecting the nation's revenues. It has not sought to help itself by enacting any scheme of regulations or other coherent plan of action to which this Court could apply the usual tools of judicial review. *See* Section E, *infra*. Instead, it seeks to be confirmed in its right to act in an *ad hoc* manner, contrary to law and history, based on the absence of practical alternatives. Such an argument would be unpersuasive even if the aggregate assessment method were in fact a real answer to an otherwise insoluble problem. In fact, the approach of assessing aggregate unreported tips is a non-solution, and the Government has substantial powers to address the actual problem at hand.

In particular, Congress has granted IRS broad powers to determine the amount of individual tips received. Through the enactment of Section 6053(c), Congress ensured IRS access to information adequate to trigger its own inquiries in cases where there is a likelihood of significant tip underreporting by employees. While it is

not the case that employers generally have superior information concerning the actual amounts of tips received by employees – and thus the core premise for shifting the burden to employers is fallacious – to the extent employers may have some information unknown to the IRS, *see* G.B. 38, n.28, any such information is readily available to the IRS through its audit and subpoena powers.

Nor is the Government limited to doing individual audits, one at a time, in order to increase the amount of individual employee tips for which employers are liable in FICA taxes. As *McQuatters, supra*, and the long line of tax court cases disclose, the flat rate approach of assessing all the servers in an establishment for their individual income taxes on additional tip income, is a frequent and successful tool used by IRS. In addition, IRS can certainly collect a substantial amount of its alleged shortfall by simply sending employers a bill for their share of FICA taxes on the additional tips their employees report directly to the IRS on Form 4137. Additional amounts could also readily be collected by pursuing by letter, the list of employees provided IRS annually to whom an allocation was made under Section 6053(c). As the documents at J.A. 68-71 and 90-93 indicate, this is precisely what Congress intended, and what IRS was actually doing before it decided it was much easier to simply "slap . . . the employer with assessments based on aggregate estimates," Pet. App. 15a. To the extent the Government perceives a need to proceed further, desk audits can be undertaken by sending the identified employees computer generated assessments for amounts in excess of the allocation.

All of these options are available to IRS at minimal time and expense. All will have the beneficial result, required by the statute, of identifying individual under-reporting employees and causing their wage earnings records to be corrected for social security benefit purposes.

Further, the figures cited by the Government, Pet. 19-20, belie its argument based on urgent necessity. IRS notes that only half of all tips were being reported 15 years ago. Pet. 19. Tip reporting has increased by 170% according to the figures presented by IRS "without any corresponding increase in industry revenues" and during the precise time that IRS had a strict policy against employer-only assessments. J.A. 103-107. Assuming the earliest figures quoted by the IRS represent reporting at the 50% level, the most recent period figures correlate with reporting at 84% of all tips received.[26] This is consistent with the fact that $11.4 billion in tips for 1997, Pet. 20, equals 9.9% of 1997 full-service restaurant sales of $112 billion. 1997 Economic Census, U.S. Bureau of Census, Summary, Accommodations and Foodservice Subject Series, Table 1. Such a level of tip reporting – 9.9% of restaurant sales – amounts to 83.3% of total tips received, if one accepts the conclusion of Treasury's *Tip*

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[26] IRS states that in 1994 total Foodservice Industry tips reported were $8.52 billion. Pet. 20. If this amount represents 50% of all tips received as IRS suggests by reference to the *Tip Income Study Id.*, total tips received would be twice that or $17.04 billion. The 1999 total tips reported for the industry of $14.31 billion, Pet. 20, is 84% of this total tips received of $17.04 billion, which IRS indicates has remained constant since 1994.

Income Study, p. 3 that tips are paid at an average rate of 11.9%.

The Government's urgent necessity argument makes no sense for another reason as well. To the extent that employee's are underreporting their tips by any significant amount, it is not only the 7.65% employer FICA tax that is going unpaid. The employee FICA tax at the same rate, and the employee income tax at a likely average rate of 15%, are also left uncollected. Thus, by failing to pursue the employee directly, and instead imposing an aggregate estimate on just the employer's share, the IRS is leaving uncollected roughly 75% of the unpaid taxes relating to underreporting of tip income. Worse, even the 25% that is being recovered is an illusion, to the extent the employer has income taxes due against which to take a credit under Section 45B. Thus, it is only the employers who are not making any profit, and therefore are unable to take that credit, who are materially impacted by the aggregate assessment of FICA taxes.

In sum, beyond the fact that the statute and legislative history clearly deny any power in the IRS to assess employer's FICA taxes based on an aggregate estimate of tips, there is no reason to accept the Government's argument that such an approach is necessary – or even desirable – in order to remedy the problem of chronic underreporting of employee tip income.

E. No Presumption Of Correctness Or Other Deference Is Due To The Government's Asserted Authority To Proceed By Aggregate Assessment

The Government leads off its argument with the assertion of a "presumption of correctness," under which the taxpayer in a refund case can only challenge an assessment by proving that the amount is erroneous, and further offering its own evidence to establish the correct amount of the tax. G.B. 10-14. This contention, of course, begs the entire question at issue in this case – whether the Government has authority under the FICA statutes to proceed by an aggregate assessment of tip income without ever focusing on the income received by individual employees. If, as Fior contends, it does not have that power, then the assessment itself is simply an unauthorized act by the IRS. It is "naked and without any foundation," *see United States v. Janis*, 428 U.S. 433, 442 (1976), and, as such, provides no basis on which to shift the burden of factual proof to the taxpayer. *Id.* at 441; *Helvering v. Taylor*, 293 U.S. 507, 514-515 (1935).

Beyond this effort to pretermit the Government's own Question Presented – addressing agency authority to impose an aggregate assessment – with a burden-shifting catch-22 argument, the Government wisely offers no further claim that deference is owed to administrative action. Plainly there is no basis here for any such claim.

When a court, employing traditional tools of statutory construction, determines that the intent of Congress has been unambiguously expressed, "that is the end of the matter; for the court, as well as the agency, must give

effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842 n.9. This is especially true here, since the IRS has not articulated a contradictory construction, except in litigation. No regulation, revenue ruling, revenue procedure, technical advice memorandum, or any other document, issued by IRS either explains the agency's current interpretation or suggests that the aggregate assessment policy is the considered enforcement policy of IRS. What does exist is either silent or explicitly states that the aggregate assessment method is *contrary* to IRS policy.[27]

Two internal documents, from 1996 and 1998, advise the IRS field officers that "any assessment made against the employer must mirror those first made against the individual employees." J.A. 106, J.A. 103-107.[28] More

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[27] The only IRS authority ever issued addressing how the employer's share of additional FICA taxes on unreported tips is to be imposed is silent as to the procedure. Rev. Rul. 95-7 1995-1 C.B. 185 poses the question: "How is a notice and demand made for purposes of section 3121(q) of the code?" and answers: "no specific form or procedure is prescribed."

[28] In the Table of Contents of the Joint Appendix, Government Counsel has elected to list these letters under the heading "Non-Record Document." That characterization is incorrect. These memoranda are issued to "Regional Chief Compliance Officer," by officials of the IRS in Washington. They were incorporated into the record, by attachment to Fior's brief in the Ninth Circuit, at the first opportunity after they were made public pursuant to a FOIA request. They were the subject of discussion in the argument before the court below, and also of post-argument correspondence with the court. There can be no doubt that they are properly part of the record before the court below, and thus part of the record before this Court. *See* S. Ct. Rule 26.1.

specifically, the second of these memoranda, issued June 24, 1998, states that:

> Assessments made against both the employer and the tipped employee should be based on amounts from either Form 4137, *Social Security and Medicare Tax on Unreported Tip income* (filed by the employee with the employee's Form 1040) or amounts reflected on Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer*, prepared at the conclusion of an employee tip examination.

J.A. 106. The same memorandum also notes:

> We have also received congressional inquires that employer-only assessments are still being performed by IRS examiners, although our current policy prevents this. Please ensure that all affected IRS personnel working on the Tip Initiative follow the current procedures related to tip examinations.

J.A. 107.

Clearly, the current contentions of the Government are nothing more than a litigating position, arrived at without rulemaking or any above-board policy formulation of any sort. "Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate." *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 213 (1988).

Under such circumstances, as this court held last term in *United States v. Mead*, 533 U.S. 218, 121 S.Ct. 2164 (2001), no deference is owed to IRS with respect to this matter. *See also Bowen*, 488 U.S. at 213 ("we have declined to give deference to an agency counsel's interpretation of

a statute where the agency itself has articulated no position on the question"); *Investment Company Institute v. Camp*, 401 U.S. 617, 628 (1971) ("the courts may not accept appellate counsel's post hoc rationalization for agency action").

CONCLUSION

For the foregoing reasons, the judgment of the Court below should be affirmed.

Respectfully submitted,

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